No. 11,322

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

UNITED STATES OF AMERICA, *Appellant,*
vs.
HOMECREST TRACT, BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, Trustee, *Appellee.*

On Appeal from the District Court of the United States for the Northern District of California.

BRIEF FOR THE UNITED STATES.

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BRIEF FOR THE UNITED STATES.

OPINION BELOW.

The District Court filed no opinion.

JURISDICTION.

The appeal involves federal income, excess profits and defense taxes with interest thereon for the taxable years 1938, 1939 and 1940, and capital stock taxes for the taxable periods ended each June 30 from 1938 through 1941. The aggregate amount involved is

$5474.97. Payments thereof were made in various amounts and upon various dates during the years 1938 to 1941, inclusive. (R. 97-98.) Separate claims for refund of each payment of taxes and interest were duly filed (R. 98-109), and were rejected by notices dated August 10, 1942, September 19, 1942, and October 1, 1942 (R. 153-155). Within the time provided by Section 3772 of the Internal Revenue Code the taxpayer brought an action on August 9, 1944, in the District Court for recovery of the taxes and interest paid. (R. 86.) Jurisdiction was conferred on the District Court by Section 24, Twentieth, of the Judicial Code, as amended. The judgment was entered on September 19, 1945. (R. 175-176.) Within three months a notice of appeal was filed on December 17, 1945 (R. 177), pursuant to the provisions of Section 128 (a) of the Judicial Code, as amended.

QUESTIONS PRESENTED.

1. Was the taxpayer taxable as an association under the provisions of Section 901 (a) (2) of the Revenue Act of 1938, c. 289, 52 Stat. 447, for the year 1938 and Section 3797 (a) (3) of the Internal Revenue Code for the years 1939 to 1941, inclusive?

2. If not, was it taxable as a trust on its undistributed income for the year 1938?

STATUTES AND REGULATIONS INVOLVED.

These will be found in the Appendix, *infra,* pages i-iv.

STATEMENT.

This action was submitted to the District Court on a written stipulation of facts, with exhibits attached (R. 95-155) and oral testimony (R. 156-171). The stipulation of facts was incorporated in the Court's findings. The material facts stipulated are as follows:

On the 28th day of January, 1926, at Bakersfield, California, 14 persons as trustors entered into a trust agreement with the Security Trust Company, as trustee, and conveyed to the trustee certain real property particularly described in the declaration of trust attached to the stipulation as "Exhibit A". On June 23, 1937, a supplemental agreement ["Exhibit B" attached to "Exhibit A"] (R. 96) was entered into between 12 trustors (eleven of the original and one new trustor), wherein it was alleged that the Bank of America National Trust and Savings Association was the successor to the Security Trust Company and as such succeeded to all the rights, powers, duties and liabilities conferred or imposed upon the latter corporation (R. 96-97).

By the terms of the original trust agreement, made a part of the stipulation of facts, it was provided that the trustors had caused or would cause to be executed and delivered to the trustee a deed conveying to it certain real property to be held in trust under the

terms and conditions and for the uses and purposes set forth in the trust. (R. 110.) These were, briefly: There should be a board of managers consisting of three beneficiaries who should be vested with the powers and responsibilities provided for them in the trust, to hold office at the pleasure of the majority of the beneficiaries; any vacancy to be filled by such majority. (R. 111.) The trustee, also called payee, was to hold the property as security for the payment to it of the sum of $14,000 as evidenced by a certain promissory note signed by the board of managers dated January 28, 1926, and for the payment to the payee of such other loans and advances as the payee might make during the continuance of the trust to the board of managers; and each trustor agreed that he, his successors and assigns, should be severally liable to the payee for the payment of the balance due on the note or notes in the proportion set opposite his name as beneficiary. (R. 111-112.)

The trustee was to subdivide and improve the real property conveyed, in such manner as might be agreed upon between the board of managers and the trustee; to have authority to dedicate to public use all streets and alleys shown upon the subdivision map to be prepared by the board and executed and acknowledged by the trustee (R. 112); to sell the real property by lot or lots free of the lien of the payee, upon such terms and conditions, to such purchasers, for such prices and payable in such manner as the trustee deemed best, provided that the sale price should not be less than that agreed upon by the trustee and the board or the

selling agent provided for by the trust, and provided further that the selling price of any parcel should not be less than an amount which bore the same ratio to the balance due the payee as the lot sold bore to the remaining unsold parcels of land (R. 112-113). The trustee was to distribute the cash proceeds from the sale of lots in a certain designated manner, including costs and expenses of the trustee; real estate commissions; release of any liens; payment of bills approved by the board for labor and material utilized for the improvement of the property; payment on notes to the payee-trustee, and the balance thereof to the beneficiaries as their respective interests might appear. (R. 113-114.)

Sale or transfer of any beneficial interest was provided for if an executed original of the assignment or other instrument evidencing such sale or transfer was filed with the trustee; and any interest could also be transferred by decree or order of court, upon satisfactory proof of the regularity and validity of the proceedings. (R. 115.) If any portion of the property should become liable for the payment of any taxes, the trustee was to have authority to withhold sufficient money and to pay such tax (R. 115); or if there were no funds available, to advance the same, this advance to be a lien on the property (R. 115-116); and the trustors agreed severally on behalf of themselves, their successors and assigns, to pay their respective proportions of all liens, encumbrances, taxes, insurance, or other charges necessary or proper for the preserva-

tion, maintenance or care of the property and the expenses of the trust (R. 116).

Provisions were made as to default, the recordation of notice thereof, and sale of the property to satisfy the debt, all at the option of the trustee (R. 117); the sale to be at public auction, either in separate parcels or of the property as a whole in the discretion of the trustee; and the proceeds from the sale to be applied on the expenses of sale, the debt, and any balance to the person legally entitled thereto (R. 118-120).

The trust was not to terminate in any event until all costs, fees, expenses, liabilities and advances of trustee, with interest, had been fully paid. (R. 120.) If the above condition was met, the beneficiaries were granted the power to revoke the trust at any time after one year from the date of its creation by notice of revocation at least 60 days prior to the effective date of the proposed revocation; reconveyances thereupon to be made to all the beneficiaries thereunder as their respective interests might appear. (R. 121.) Fees for services rendered by the trustee were also provided. (R. 122-123.) A selling agent was designated and the trustee was to execute conveyances or contracts for sale of lots upon request of the agent. (R. 120-121.) The supplementary agreement dated June 23, 1937, merely substituted the Bank of America National Trust and Savings Association as trustor in place of the former trust company (R. 124); provided for the making of new advances to the beneficiaries by the new trustee, and provided that the then bene-

ficiaries of the trust were to be proportionately liable for their repayment (R. 125-127).

The remaining facts stipulated to herein were the amount of tax payments made by the trust, fully itemized, and totalling $5474.97; the dates of their respective payments (R. 97-98); the filing of claims for the return thereof, and the rejection of these by the Commissioner of Internal Revenue, with notice to the trustee (R. 98-109). Copies of all of these documents are attached to the stipulation of facts as exhibits. (R. 128-155.)

The transcript of record shows that it was stipulated at the trial that an amended answer was filed setting up a counterclaim on behalf of the Government, taxing the plaintiff as a true trust on its undistributed income, in the event it should not be found taxable as an association, and a further stipulation to the effect that this new matter should be deemed denied by plaintiff (R. 157-158); and it was further stipulated that in the event plaintiff should be found to be a true trust, and taxable as such, the computation of $400.01 should be deemed the correct amount of tax for the year 1938 and that there was then no tax liability for the years 1939 and 1940 (R. 158-159).

Based upon testimony of the assistant trust officer of the Bank of America in Bakersfield (R. 160-168) the District Court also found as facts: that the trust had no offices; it had no officers, except as the board of managers might be so construed to be (R. 172); the trust issued no shares, or certificate or other evi-

dence of interest therein and had no stock ledger, or stock certificate book or any books in lieu thereof; it had no seal, by-laws or minute book; it had no employees other than the board of managers and selling agent; and the trust had no meetings (R. 173).

Upon the above findings the District Court concluded that: the trust created on January 28, 1926, was, and is, not an association taxable as a corporation within the meaning of Section 901 (a) (2) of the Revenue Act of 1938 and Section 3797 (a) (3) of the Internal Revenue Code; that income of the trust is not taxable to the trust under Section 162 of the Internal Revenue Code, and that the plaintiff is entitled to judgment for the taxes involved in the action with interest from the payment dates. (R. 173-174.)

STATEMENT OF POINTS TO BE URGED.

The District Court erred:

1. In concluding that the trust created on or about January 28, 1926, was not and is not an association taxable as a corporation within the meaning of Section 901 (a) (2) of the Revenue Act of 1938 and Section 3797 (a) (3) of the Internal Revenue Code;

2. In concluding that plaintiff is entitled to recover costs against the defendant;

3. In that the findings of fact do not support the conclusions of law;

4. In that the findings of fact do not support the judgment;

5. In failing to make a finding that the trust in question, if not taxable as an association, was taxable for the year 1938 as a trust on its undistributed income;

6. In concluding that plaintiff is entitled to judgment against defendant, and in entering judgment for defendant and in not entering judgment for plaintiff.

SUMMARY OF ARGUMENT.

The taxpayer trust is an association taxable as a corporation because it was organized by an association of individuals as a medium for the carrying on of a business enterprise for profit and it has the salient features of a business trust, making it analogous to a corporation.

The trust was created as a business enterprise, thus complying with the first essential for classification as a taxable association under controlling decisions of the Supreme Court and other federal courts. The primary purpose of the trust was to improve, subdivide and sell a tract of land.

The trust has the salient features of a business trust making it analogous to a corporation. (1) Title to the property was held by the trustee as a continuing entity. There is no specific provision for succession in the trust agreement, but the trustee was a financial corporation in which continuity is inherent. The original trustee was in fact succeeded by the present trustee. (2) Centralized management is effected by

a board of managers who, with the trustee, was to improve and subdivide the property, fix prices, execute conveyances, collect and distribute income—the board of managers and the trustee were to conduct the enterprise in much the same manner as directors. (3) Security from interruption by death is provided for, since the continuance of the trust is not affected in any way by death of any of the beneficiaries. (4) Transfer of beneficial interests is provided for and some transfers were actually made. (5) The liability of each trustee for obligations, expenses and charges against the trust is limited to the same proportion of those charges as his interest in the trust. These are the criteria established by the Supreme Court in determining whether a trust is a taxable association.

If the trust is not taxable as an association then it is taxable as a pure trust on its undistributed income. The District Court erred in holding that the trust was not taxable on the theory that it was a revocable trust, the income of which was taxable to the grantors under Section 166 of the Internal Revenue Code. Section 166 applies only when there is power to revest in the grantor the corpus of the trust by action of the grantor alone or in conjunction with any person not having a substantial adverse interest in the disposition of the corpus or income. Here the grantors who were also the beneficiaries had substantial interests adverse to each other since each is bound to assume his proportionate share of the obligations and liabilities of the trust. Accordingly, Section 166 does not apply.

ARGUMENT.

I.

THE TAXPAYER TRUST CONSTITUTED AN ASSOCIATION TAXABLE AS A CORPORATION WITHIN THE MEANING OF THE APPLICABLE INTERNAL REVENUE LAWS.

The contentions of the parties of this action are briefly:

The Government contends that the taxpayer trust is an association taxable as a corporation because it was organized by an association of individuals as a medium for the carrying on of a business enterprise for profit and it has the salient features of a business trust making it analogous to a corporation.

The taxpayer contends that it is purely a loan-security and liquidation trust having non-business purposes and that it is not an association taxable as a corporation.

This Court has passed upon the question whether an organization is a business trust taxable as a corporation in many cases, among them *Willis v. Commissioner,* 58 F. (2d) 121; *Porter v. Commissioner,* 130 F. (2d) 276; *Sloan v. Commissioner,* 63 F. (2d) 666; *Title Insurance & Trust Co. v. Commissioner,* 100 F. (2d) 482; *Commissioner v. Security-First Nat. Bank,* 148 F. (2d) 937.

In the *Security-First National Bank* case, *supra,* the Court held (pp. 938-939):

> The character of the organization as to whether or not it is a "business trust," is determined by what the instruments creating the trust empowered the trustee to perform, and not by what

powers the trustee actually exercised. This appears in *Morrissey v. Commissioner of Internal Revenue,* 296 U. S. 344, 357, 56 S. Ct. 289, 295, 80 L. Ed. 263, in the words "but the *nature* and *purpose* of the cooperative undertaking will differentiate it from an ordinary trust," and in the companion case of *Helvering v. Coleman-Gilbert,* 296 U. S. 369, 374, 56 S. Ct. 285, 287, 80 L. Ed. 278, where the Supreme Court, in speaking of the "purpose" appearing in the instrument creating the trust, states "The parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted."

Here the trustee was empowered to receive the royalties from the oil and gas leases in kind. This would require it to conduct the business of selling the oil or gas to obtain the cash to be distributed to the beneficiaries. The trustee was also empowered to engage in the business of "rent [ing and] leas [ing the trust property] for other than oil or gas purposes" and sell or convey it outright. The organization was thus purposed to engage in business within the *Coleman-Gilbert* decision, *supra.* Cf. *Kettleman Hills Royalty Syndicate No. 1 v. Commissioner of Internal Revenue,* 9 Cir., 116 F. (2d) 382, 383, certiorari denied 313 U. S. 582, 61 S. Ct. 1100, 85 L. Ed. 1538.

The organization otherwise complied with the criteria of the *Morrissey* case, *supra,* showing it analogous to a corporation (1) holding title to the trust property by the trustee; (2) centralized management in the trustee; (3) continuity of the trust enterprise uninterrupted by the deaths of

the owners of the beneficial interests; (4) transferable beneficial interests; and (5) limitation of personal liability of the participants as for the stockholders of a corporation.

The Government contends that the Homecrest Tract trust also was created as a business enterprise and otherwise complied with the criteria of *Morrissey v. Commissioner,* 296 U. S. 354, showing it analogous to a corporation.

(a) The trust was created as a business enterprise.

In order that a trust be taxable as an association the first essential is that it be organized for business purposes. In the *Morrissey* case, *supra,* it was held (pp. 356-357):

> "Association" implies associates. It implies the entering into a joint enterprise, and, as the applicable regulation imports, an enterprise for the transaction of business. This is not the characteristic of an ordinary trust—whether created by will, deed, or declaration—by which particular property is conveyed to a trustee or is to be held by the settlor, or specified trusts, for the benefit of named or described persons. Such beneficiaries do not ordinarily, and as mere cestuis que trustent, plan a common effort or enter into a combination for the conduct of a business enterprise. Undoubtedly the terms of an association may make the taking of acquiring of shares or interests sufficient to constitute participation, and may leave the management, or even control of the enterprise, to designated persons. But the nature and purpose of the cooperative undertaking will differentiate it from an ordinary trust. In what

> are called "business trusts" the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gains. Thus a trust may be created as a convenient method by which persons become associated for dealings in real estate, the development of tracts of land, the construction of improvements, and the purchase, management and sale of properties; or for dealing in securities or other personal property; or for the production, or manufacture, and sale of commodities; or for commerce, or other sorts of business; where those who become beneficially interested, either by joining in the plan at the outset, or by later participation according to the terms of the arrangement, seek to share the advantages of a union of their interests in the common enterprise.

It is clear that the trust here involved was more than an ordinary trust created for the purpose of protecting or conserving property, and that it was created for purposes far beyond those of a trust for mere security or liquidation purposes, as was maintained by the taxpayer in the Court below.

In determining whether the trust was organized for business purposes the agreement must be examined in detail and as a whole. By doing that it is clearly disclosed that the trust was created as a "convenient method by which persons became associated for dealings in real estate, the development of a tract of land, and the construction of improvements; where those who became beneficially interested sought to share the advantages of a union of their interests in the common

enterprise." *Morrissey v. Commissioner, supra.* It is clear, moveover, that the primary purpose for organization of the trust was to improve, subdivide and sell a tract of land at a profit, which was a definite business enterprise.

Under the terms of the trust agreement entered into at Bakersfield, California, on January 14, 1926, fourteen individuals conveyed by deed to Security Trust Company, as trustee, a quarter section of real property situated in Kern County, California. (R. 110.) A board of managers consisting of three beneficiaries was appointed, with powers and duties as prescribed in the instrument. (R. 111.) The trustee, also called the payee, loaned $14,000 to the trust concurrently with execution of the agreement and it was provided that the trustee should hold the real property as security for that loan and other loans and advances which might be made to the trust during its existence. (R. 111-112.)

The trustee was directed to subdivide and improve the property. A map of the new subdivision was to be prepared by the board of managers and executed and recorded by the trustee. Streets and alleys shown on the map were dedicated by the trustee to public use. (R. 112.) The trustee was to sell the lots free of its lien (the trustee's lien) upon such terms and conditions and for such prices as the trustee might deem best. (R. 112-113.) The only restriction upon the trustee was that the sale prices of lots should not be less than those agreed upon by the trustee and the board of managers or the selling agent. (R. 113.)

The trustee was to receive the proceeds and distribute the funds. (R. 113.) That a profit was contemplated is very apparent from the provision for minimum sale prices of the lots and from the careful enumeration of the expenses and outlays which were first to be taken care of, after which the beneficiaries were to receive their proportionate shares of the proceeds. (R. 113-114.) Obviously substantial income and profits were received each year, since the taxes assessed are not insubstantial. (R. 97-98.) The record does not show what proportions of the income were from cash sales, contracts or rents. The agreement provided that the trustee should not collect or disburse rentals, but that the trustors themselves should. (R. 116-117.) [However, the collection of rentals was contemplated, and that in itself denotes business activity.] Neither does it show the amounts expended for improvements, labor or materials. However, improvements were clearly contemplated and their payment provided for. (R. 112, 114.) It may fairly be inferred that the expense of laying out and improving the tract was considerable in amount. The initial loan required to start the project was $14,000 (R. 111-112), and the agreement provided for additional loans as required for trust purposes. (R. 112.) No limit was provided as to the amount that the board of managers might borrow or expend in improving or developing the subdivision.

The agreement provided that the trustee should commence or defend suits with respect to the property upon written request of the trustors or beneficiaries,

accompanied by a sufficient sum of money for the purpose. (R. 117.) Detailed procedure to be taken by the trustee in the case of default in payment of debts to the trust or to the trustee is provided in the agreement (R. 117-119) and the method and order of precedence in distributing the proceeds of property in cases of default are specified. (R. 119-120.)

One of the beneficiaries of the trust was designated as the selling agent of the land. It was provided that the trustee would make sales of any lots in the subdivision in accordance with the terms of written requests by the trustee. (R. 120-121.) But only the trustee could execute deeds or contracts with respect to the property. (R. 117.)

The Government submits that it is abundantly clear from the terms of the trust instrument that the organization was purposed to engage in business. There was no evidence at the trial below as to the activities actually engaged in by the trust. Except with respect to the capital stock taxes involved it is immaterial whether or not the trust exercised its business purposes. It was empowered to engage in business and therefore should be classified as a taxable association. *Morrissey v. Commissioner,* 296 U. S. 344. However, the taxpayer nowhere asserts that the trustee did not exercise all of its powers, functions and duties, but merely asserts that the duties were ministerial in nature only. (R. 129.) But it is apparent that the trust was carrying on its business activities. How else could it have earned the substantial income it did each year?

In addition to decisions involving the question of taxability of business trusts this Court has had for decision the question of what constitutes business in many cases involving the capital stock tax, among them *United States v. Hercules Mining Co.,* 119 F. (2d) 288, certiorari denied, 308 U. S. 617; *Barker Bros. Corp. v. Rogan,* 126 F. (2d) 917; *United States v. Western Shore Lumber Co.,* 136 F. (2d) 628; and *Section Seven Corp. v. Anglim,* 136 F. (2d) 155. In order that corporations be liable for the capital stock tax it is necessary not only that they be organized to engage in business for profit but that they actually engage in business. Obviously, however, the definitions and tests as to what constitutes business must be the same whether the question at issue is the power to do business or the actual carrying on of business.

In the *Section Seven Corporation* case, *supra,* there is a rather exhaustive discussion of the Supreme Court cases dealing with the "doing business" question. Following those decisions it was held (p. 158) that if a corporation was organized for profit and was doing what it was principally organized for in order to realize profit, no special volume of business is necessary to bring it within the taxing act—a very slight activity may be deemed sufficient to constitute "doing business." *Flint v. Stone Tracy Co.,* 220 U. S. 107; *Von Baumbach v. Sargent Land Co.,* 242 U. S. 503; *Edwards v. Chile Copper Co.,* 270 U. S. 452.

We feel safe in saying that this Court and other federal Courts have held that organizations were empowered to and did carry on business where consider-

ably less activity was disclosed than in this case. For instance Section Seven Corporation was organized to draw into a single possession the various interests in the land, to clear the title, to enter into an oil and gas lease, to receive the royalties, to determine whether they should be collected in cash or kind and, by reasonable implication, to enforce the terms of the lease, and to distribute the income. It executed rights of way over the land in favor of third persons. This Court said (p. 159):

> With a full knowledge of all this [the activities above enumerated], we must decline to say that Section Seven Corporation, in doing what it was organized to do, was not doing business.

Incidentally, it may be noted that in the *Section Seven* case, *supra,* the incorporators owned separate portions of the tract before the organization was formed. In briefs filed in the Court below in this case the taxpayer attached great significance to the fact that these trustors owned individual portions of the tract before the trust was formed. It was argued that this distinguished the case from some others cited by the Government where trusts were formed, and with money furnished by the trustors, property was acquired. It was said that where property was to be acquired there could be no question that the trust was to engage in business, rather than merely to liquidate property already owned, as was claimed to be the situation in this case.

In the *Section Seven* case, *supra,* this Court said (pp. 158-159):

> Respecting the option in the contract to take the royalties in cash or in kind, the taxpayer contends that because unless the option was exercised the royalties were to be paid in cash and the option to take in kind was not exercised, the mere power to elect does not constitute "doing business." A short answer is that it is the exercise of the judgment to take in cash or in kind that constitutes a business activity; in a word the taxpayer elected not to exercise the option, which is a business activity. Besides, this court heretofore has said: "It is our opinion that in making these successive decisions whether it will require the delivery of the royalty product in kind or in cash, the taxpayer is making a succession of business judgments and 'is doing the business' within the decision of *Morrissey v. Commissioner,* 296 U. S. 344, 360, 56 S. Ct. 289, 80 L. Ed. 263."
>
> *Kettleman Hills Royalty Syndicate No. 1 v. Commissioner,* 9 Cir., 116 F. (2d) 382, 383.

We think it is quite apparent that the business activities of the Section Seven Corporation Trust were much less than those of the Homecrest Tract Trust.

In *Barker Bros. Corp. v. Rogan,* 162 F. (2d) 917 (C.C.A. 9th), the corporation was held to be doing business although its only activities were in transactions with two subsidiaries. The company borrowed money from one subsidiary to be used in aiding the other subsidiary in acquiring a leasehold and collected moneys due it under the transaction and made payments on its loans. Again, the business activities carried on appear to be much less than those in this case.

In *United States v. Western Shore Lumber Co., supra,* the corporation was organized to acquire timber lands and to cut and market the timber. But it ceased active operations long prior to the taxable years involved. Its intention before and during the taxable years in question was to effect liquidation by selling its timber lands as a whole. It collected sums from a lumber company under a stumpage contract. This timber was cut from an isolated section of the taxpayer's properties which rendered that land valueless and amounted in essence to a liquidation of the property from which the timber was cut. Upon these slight activities it was held that the corporation was not dormant but was doing business.

The taxpayer contended in the Court below that no business purpose was shown and that it was merely a liquidating trust for the security of the bank. Cases cited by the taxpayer are clear liquidation trust cases with which we do not disagree since they are correct on their facts, but in no way analogous to this case. *Girard Trust Co. v. Commissioner,* 34 B.T.A. 1066; *Broadway-Brompton Building Liquidation Trust v. Commissioner,* 34 B.T.A. 1089; *Pitzman v. Commissioner,* 36 B.T.A. 81. The distinction is pointed out by this Court in *Willis v. Commissioner,* 58 F. (2d) 121, where it is said (p. 122):

> * * * Simply stated, the question is, did the trustees manage and operate the property in their charge as a business, with the purpose to accumulate a profit by the use of it, or was their sole purpose, intended and pursued, to dispose of it as rapidly as possible, market conditions con-

> sidered, and divide the proceeds among the beneficiaries? As a liquidating trust purely, the income would not be taxable; as a business venture the income would be taxable. The distinction is made clear in the cases: *Hecht v. Malley,* 265 U. S. 144, 44 S. Ct. 462, 68 L. Ed. 949; *Blair v. Wilson Syndicate Trust,* 39 F. (2d) 43 (C.C.A. 5); *Commissioner v. Atherton,* 50 F. (2d) 740 (C.C.A. 9); * * *

In the *Willis* case the Court held that the trustees went beyond the single purpose of effecting a liquidation of assets, and for that reason the collection of income taxes was proper.

The trust involved in the present case is a liquidating trust only in the sense that it is inevitable, in the nature of things, that every trust contemplating the creation of a real estate subdivision and the sale of lots is eventually liquidated by the sale of all the lots. Here the sole purpose was not to dispose of the property as rapidly as possible and divide the proceeds among the beneficiaries. On the contrary, the purpose was to subdivide and improve the property and to sell lots for cash or on contracts—clearly a business enterprise with profit motives.

The following appears as the syllabus in the case of *Magruder v. Washington B. & A. Realty Corp.,* 316 U. S. 69-70:

> 1. A corporation which was organized for the purpose of liquidating the properties of another corporation, and which, since its organization, has been carrying on negotiations for the sale of the properties, selling them from time to time as

satisfactory offers are received, and renting unsold properties under short term leases in an attempt to earn the carrying charges pending ultimate sale, was "carrying on or doing business" within the meaning of provisions of the Revenue Act of 1935, and subsequent Revenue Acts, imposing a tax on the capital stock of every domestic corporation "carrying on or doing business" during the tax year. P. 71.

2. The provision of the Treasury Regulations that "doing business" within the meaning of the capital stock tax provisions of the Revenue Act of 1935, and subsequent Revenue Acts, includes activities of a corporation engaged in "liquidation * * * of properties taken over from another corporation" is valid and applicable to the corporation here involved. P. 72.

The Court noted (pp. 73-74) that Article 43(a) (5) of Treasury Regulations 64 (1936 ed.) is both a contemporary and a long standing administrative interpretation, and that it was continued in the 1938 edition of Regulations 64, which is applicable to the present case.

We submit that the *Washington B. & A. Realty Corporation* case is controlling here. Capital stock taxes are involved in this case as well as income and excess profits taxes. (R. 97-98.) Moreover, we believe it is apparent that the business activities of this taxpayer were more extensive than those of the taxpayer in the Supreme Court case. In this case the trust not only took over the real estate of the trustors for the purpose of sale but the trustee was required to

subdivide and improve the property to sell it at advantage and for profit.

(b) The trust has the salient features of a business trust making it analogous to a corporation.

In the *Morrissey* case, *supra,* the Court enumerated certain salient features as rendering a trust analogous to a corporation. We believe that all of those features are present in the Homecrest Tract Trust. They are (1) *The holding of title to the trust property by the trustee as a continuing body with provision for succession.* There can be no question but that it was intended that the trustee should hold title to the real estate throughout the life of the trust. There is no specific provision for succession in the trust agreement. But that omission is not of consequence under the circumstances here. The fact that a financial corporate trustee was chosen indicates that continuity was contemplated for the trust term. The corporate nature of the trustee has the element of continuity inherent in itself. Moreover, any failure to name or specifically provide for a successor trustee is answered by the fact that the original corporate trustee was succeeded by the present corporate trustee. (2) *Centralized managment in the trustee.* Centralization of management is effected by a board of managers who, together with the trustee, were to subdivide and improve the property, to effect the execution of documents and conveyances, to accept and repay loans, to collect and distribute income and to pay expenses. In brief the board of managers and the trustee are charged

with the conduct of the enterprise in "much the same manner as directors". *Morrissey v. Commissioner, supra.* (p. 359.) (3) *Security from termination by death of beneficiaries.* Security from termination or interruption by death of the owners of beneficial interests is provided for, since the continuance of the trust is not affected in any way by the death of any of the beneficiaries. (4) *Transferable beneficial interests.* Transfer of beneficial interests by the beneficiaries is provided for, the only requirement being that an executed original of the instrument evidencing the transfer be filed with the trustee. Transfer of beneficial interests by Court order is also contemplated and provided for. (R. 115.) Transfers of beneficial interests actually were made since fourteen original trustors entered the agreement of January 28, 1926 (R. 114-115), and the supplemental agreement of June 23, 1937, was entered into by twelve trustors, eleven of the original and one new trustor. (R. 127-128.) (5) *Limitation of personal liability.* The trust agreement provides that each trustor or his successor shall be severally liable to the payee for payment of the balance due on notes given for loans in the proportion set opposite his name as beneficiary (R. 112) and the trustors severally agreed to pay, when due, their respective proportions of all liens, taxes, etc. against the property and other charges or indebtedness and expenses of the trust. (R. 116.)

The taxpayer contended below that this was not the sort of limited liability contemplated by the Supreme Court in the *Morrissey* case, *supra,* where the follow-

ing sentence appears (p. 359): "The trust method also permits the limitation of personal liabilty of participants to the property embarked in the undertaking." It appears that a similar contention was made in the case of *Commissioner v. Security-First Nat. Bank* but this Court rejected it saying (p. 939):

> With regard to the limitation of personal liability, it is limited to assessments by the trustee on the beneficiaries for no more than "his proper proportion" of the debts and liabilities incurred in the administration of the trust property. The California corporate law comprehends such assessment of corporate shareholders. Section 331 of the Civil Code of California provides in paragraph (1) thereof that "Shares issued by stock corporations are not assessable except as provided in this article. If the articles expressly confer such authority upon the corporation or the board of directors, and subject to any limitations therein contained, the directors may in their discretion, levy and collect assessments upon all shares of any or all classes made subject to assessment by the articles. * * *" Prior to 1930 the California constitution by Article XII, Section 3, made mandatory such proportionate liability of shareholders.

We believe that it has been demonstrated above that the trust in this case complied with *all* of the criteria of the *Morrissey* case, *supra,* showing it analogous to a corporation. However, even if there is not strict compliance it should not affect the decision of the case. If a trust is designed to operate a profitable enterprise with the comparative facility and to serve the

purposes of a corporate unit so as to dispense with the necessary activity and concurrence of numerous individuals, the absence of any of the tests set out in the *Morrissey* case, *supra,* will not take the trust out of the category of a taxable association within the Revenue Acts in question. *Fidelity Bankers Trust Co. v. Helvering,* 113 F. (2d) 14 (App. D.C.); *Merchants Trust Co. v. Welch,* 59 F. (2d) 630 (C.C.A. 9th).

The Government does not consider that it is necessary or that it would be helpful to this Court to review a large number of the authorities dealing with the question whether a trust is or is not a business trust and therefore taxable as a corporation. After all, the decision in each case must depend upon the particular trust agreement before the Court. *Commissioner v. Security First Nat. Bank, supra.* That recent decision, we believe, is indistinguishable in principle and it is determinative of the issues here. In the Court below the taxpayer contended that the cases are distinguishable in that the Security trust was formed to acquire property and could enter into the oil business, while in the instant case the trust was formed to liquidate the property. We believe that we have effectually disposed of the taxpayer's contention above.

All of the following cases, we submit, fully support the Government's contention that the taxpayer was an association taxable as a corporation. *Morrissey v. Commissioner,* 296 U. S. 344; and associated cases; *Willis v. Commissioner,* 58 F. (2d) 121 (C.C.A. 9th); *Porter v. Commissioner,* 130 F. (2d) 276 (C.C.A. 9th);

Fidelity-Bankers Trust Co. v. Helvering, 113 F. (2d) 14 (App. D.C.); *Sloan v. Commissioner,* 63 F. (2d) 666 (C.C.A. 9th); *Title Insurance & Trust Co. v. Commissioner,* 100 F. (2d) 482 (C.C.A. 9th); *Commissioner v. Vandegrift R. & Inv. Co.,* 82 F. (2d) 387 (C.C.A. 9th); *Del Mar Addition v. Commissioner,* 113 F. (2d) 410 (C.C.A. 5th); *Wellston Hills Syndicate Fund v. Commissioner,* 101 F. (2d) 924 (C.C.A. 8th). Of course, there are variations in the terms of the trust agreements involved in the cases. But we see no point in comparing the various agreements item by item with the agreement in the present case to show similarities or, perhaps, to reconcile differences. The strength of the authorities is that in each case, under the terms of the respective agreements, which were in controlling effect similar to the agreement in this case, it was held that the trusts were taxable associations because they were created for business purposes and had features analogous to corporations.

The taxpayer in the Court below placed chief reliance on the case of *Lewis & Co. v. Commissioner,* 301 U. S. 385, which, it was claimed, is the only truly parallel case to the one at bar. We believe the situations in the two cases are in no sense parallel, but that they are quite different in many important and controlling features. In the *Lewis* case, *supra,* a landowner made a declaration placing title in a corporate trustee for the benefit of herself and an agent empowered by her to sell the land, whose compensation was to be a fixed percentage of payments made by purchasers. The only functions of the trustee were to

hold the title, execute contracts and conveyances at the direction of the agent, and to make collections. It was held that the trust was not an association taxable as a corporation.

The Supreme Court distinguished the case in detail from the *Morrissey* case, *supra.* The same distinctions prevail here. It was held (p. 387) that if it were not for the declaration of trust, it would be a simple case of an appointment by a landowner of an agent to subdivide the land and sell it, and to receive as compensation for his services a fixed percentage of the payments made by the purchasers. The Court held that the intervention of the trustee to hold title, make conveyances at the direction of the agent and to make collections did not alter the situation.

In distinguishing the *Morrissey* case, *supra,* the Court first pointed out that there the trust was a medium for carrying on a business enterprise by the trustee and participation in the profits by numerous beneficiaries whose interests were represented by transferable certificates, thus permitting the introduction of new participants, without affecting the continuity of the plan. (pp. 387-388.) Except for the issuance of certificates the same situation exists in this case. Here there was contemplated a business enterprise by the trustee; numerous beneficiaries participated in the profits; transfers of the interests of beneficiaries were provided for and actually consummated without affecting the continuity of the plan. Next, the Court said that it had been pointed out in the *Morrissey* case, *supra,* that the corporation an-

alogy was evidenced by centralized control, continuity and limited liability. (p. 388.) We believe it has been adequately demonstrated above that the same factors are present in this case. The Court then refers to the statement in the *Morrissey* case, *supra,* that the word "association" implies associates. (p. 388.) In the *Lewis* case, supra, there were no associates; in the present case, of course, the associates were numerous. Then the Court quoted from its earlier decision to the effect that "association" implies entering into a joint enterprise for the transaction of business. We have dealt with this phase of the present case above and, we believe, established that we have here a joint business enterprise. It was held that the arrangement in the *Lewis* case, *supra,* answered the description of an ordinary trust—by which particular property is conveyed to a trustee on specified trusts for the benefit of named or described persons who do not ordinarily, and as mere *cestuis que trustent* enter into a combination for the conduct of a business enterprise. The trust in the *Lewis* case, *supra,* it was held, was adopted merely as a convenient means of making effective the sales of the agent under his contract. Further, it was held that the duties of the trustee were purely ministerial, with no power to control, direct, or participate in the contemplated selling enterprise. Quite in contrast the trustee in the present case was itself to subdivide, improve and sell the property, dedicate part of it to public use, pay bills for labor and material, receive all proceeds (except rents) and disburse the funds, foreclose upon de-

fault, convey lots and clear titles, and fix sales prices, terms and conditions of sales jointly with the board of managers and the selling agent.

In the *Lewis* case, *supra,* the Supreme Court held further that there was to be found in the operation of the business no essential characteristic of corporate control—nothing analogous to a board of directors or shareholders, no exemption from personal liability, no issue of transferable certificates of interest. With the exception of transferable certificates, we feel that it has been adequately demonstrated above that all of the factors found wanting to establish an association in the *Lewis* case, *supra,* are present in the case at bar. The *Lewis* case, *supra,* far from supporting the taxpayer's contentions, serves to emphasize the distinction between the Homecrest Tract Trust and an ordinary trust and fully supports the Government's position that this taxpayer should be held to be an association taxable as a corporation.

It is apparent that the trust agreement in this case falls squarely within the applicable regulation as an association taxable as a trust. Treasury Regulations 103, Section 19.3797-3, Appendix, *infra.* The regulation for the most part merely paraphrases the language of the Supreme Court and other federal courts with respect to various provisions and circumstances presented in the large number of cases involving the distinction between an association and an ordinary trust. The taxpayer, in the Court below, attached some weight to the fact that this trust did not have certain attributes, forms or activities generally found in corpo-

rate organizations. But the omission or lack of any or all of the conditions or circumstances stressed by the taxpayer is held to be of no consequence by the regulation which is as follows, in part:

> The effectiveness in action in the case of a trust or of a corporation does not depend upon technical arrangements or devices such as the appointment or election of a president, secretary, treasurer, or other "officer", the use of a "seal", the issuance of certificates to the beneficiaries, the holding of meetings by managers or beneficiaries, the use of a "charter" or "by-laws", the existence of "control" by the beneficiaries over the affairs of the organization, or upon other minor elements. They serve to emphasize the fact that an organization possessing them should be treated as a corporation, but they are not essential to such classification, for the fundamental benefits enjoyed by a corporation, as outlined above, are attained, in the case of a trust, by the use of the trust form *itself*. The Internal Revenue Code disregards the technical distinction between a trust agreement (or declaration) and ordinary articles of association or a corporate charger, and all other differences of detail. It treats such a trust according to its essential nature, namely, as an association. This is true whether the beneficiaries form the trust or, by purchase or otherwise, acquire an interest in an existing trust."

The regulation is both a contemporary and a long standing administrative interpretation. We submit that it is valid, as well as applicable. *Magruder v. Washington B. & A. Realty Corp., supra.* We submit that under the applicable internal revenue laws, the

regulations promulgated thereunder and controlling court decisions the taxpayer was an association taxable as a corporation, and that the taxes involved in this action were legally and properly assessed and collected.

II.

IF THE TRUST IS NOT TAXABLE AS AN ASSOCIATION, IT IS TAXABLE AS A TRUST ON ITS UNDISTRIBUTED INCOME FOR THE YEAR 1938.

In the District Court the Government raised the alternative contention that if the trust was not taxable as a corporation, then it was taxable as a true trust on its undistributed income for the year 1938. (R. 157-158.) The parties stipulated at the trial as to the amount of tax that would be due if the trust were found to be a true trust, and taxable as such. (R. 158-159.)

The Government's contention was based on the provisions of Section 162 of the Internal Revenue Code, as follows:

> Sec. 162. NET INCOME.
>
> The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—
>
> * * * * * * *
>
> (26 U.S.C. 1940 ed., Sec. 162.)

The taxpayer contended that under Section 166 of the Internal Revenue Code the income was taxable to the beneficiaries because of the trustor's power to revoke. Section 166 is as follows:

Sec. 166. REVOCABLE TRUSTS.

Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—

(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or

(2) in any person, not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, then the income of such part of the trust shall be included in computing the net income of the grantor. (26 U.S.C. 1940 ed., Sec. 166.)

The District Court concluded that the income of the trust is not taxable to the trust under Section 162. (R. 173.)

We believe the District Court erred in holding that the trust was not taxable on its undistributed income under Section 162. The Court assigned no reason for the conclusion reached in this connection. By implication, however, it would appear that the Court considered that the grantors, who were also the beneficiaries, had no substantial adverse interests in the disposition of the trust nor substantial interests adverse to each other. The Government contended below and now contends that it is obvious that the grantors do have substantial interests adverse to each other in view of the fact that each is bound to assume his proportionate share of the obligations and liabilities of the trust to the extent of his particular bene-

ficial interest. (R. 121.) Revocation of this trust could be effected only by the united action of 12 or 14 grantors and beneficiaries, each with an interest adverse to each of the others. It might well be that one or more of the grantors and beneficiaries would consider his interests against revocation—in that event the trust could not be revoked. Cf. *Smith v. Commissioner,* 59 F. (2d) 56 (C.C.A. 1st); *Jones v. Commissioner,* 27 B.T.A. 171; and *Litchfield v. Commissioner,* 39 B.T.A. 1017.

The taxpayer relied in the Court below on *Bromley v. Commissioner,* 66 F. (2d) 552 (C.C.A. 3d), and *Crossett v. United States,* 30 F. Supp. 802 (C. Cls.), where, as in this case, there were more than one grantor, but it was held that the use of the word "grantor" in the singular in the statute should be construed to mean the plural as well. But our contention is not based upon the plurality of the grantors. Concededly they could revoke the trust if they acted in concert. However, as beneficiaries their interests were adverse and therefore it would seem that Section 166 of the Internal Revenue Code does not apply in this case.

CONCLUSION.

The District Court erred in concluding that the taxpayer trust is not an association taxable as a corporation within the meaning of Section 901 (a)(2) of the Revenue Act of 1938 and Section 3797 (a)(3) of the Internal Revenue Code.

In the alternative, the District Court erred in concluding that the trust was not taxable (on its undistributed income for 1938) as an ordinary trust.

The judgment entered by the District Court is erroneous and should be reversed.

Dated, August 5, 1946.

Respectfully submitted,

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(Appendix Follows.)

Appendix.

Appendix

Revenue Act of 1938, c. 289, 52 Stat. 447:

Sec. 901. DEFINITIONS.

(a) When used in this Act—

* * * * * * *

(2) The term "corporation" includes associations, joint-stock companies, and insurance companies.

* * * * * * *

Internal Revenue Code:

Sec. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * * * *

(3) *Corporation.*—The term "corporation" includes associations, joint-stock companies, and insurance companies.

* * * * * * *

(26 U.S.C. 1940 ed., Sec. 3797.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

These Regulations are applicable to the years 1939, 1940 and 1941. The Regulations applicable to the taxable year 1938 are Regulations 101, Art. 901-3, the provisions of which are identical with those of the Regulations hereinafter quoted.

Sec. 19.3797-3. *Association distinguished from trust.*—The term "trust" as used in the Internal Revenue Code, refers to an ordinary trust,

namely, one created by will or by declaration of the trustees or the grantor, the trustees of which take title to the property for the purpose of protecting or conserving it as customarily required under the ordinary rules applied in chancery and probate courts. The beneficiaries of such a trust generally do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. Even though the beneficiaries do create such a trust, it is ordinarily done to conserve the trust property without undertaking any activity not strictly necessary to the attainment of that object.

As distinguished from the ordinary trust described in the preceding paragraph there is an arrangement whereby the legal title to the property is conveyed to trustees (or a trustee) who, under a declaration or agreement of trust, hold and manage the property with a view to income or profit for the benefit of beneficiaries. Such an arrangement is designed (whether expressly or otherwise) to afford a medium whereby an income or profit-seeking activity may be carried on through a substitute for an organization such as a voluntary association or a joint-stock company or a corporation, thus obtaining the advantage of those forms or organization without their disadvantages. The nature and purpose of a cooperative undertaking will differentiate it from an ordinary trust. The purpose will not be considered narrower than that which is formally set forth in the instrument under which the activities of the trust are conducted.

If a trust is an undertaking or arrangement conducted for income or profit, the capital or property of the trust being supplied by the bene-

ficiaries, and if the trustees or other designated persons are, in effect, the managers of the undertaking or arrangement, whether the beneficiaries do or do not appoint or control them, the beneficiaries are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association, and the undertaking or arrangement is deemed to be an association classified by the Internal Revenue Code as a corporation. However, the fact that the capital or property of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association.

By means of such a trust the disadvantages of an ordinary partnership are avoided, and the trust form affords the advantages of unity of management and continuity of existence which are characteristic of both associations and corporations. This trust form also affords the advantages of capacity, as a unit, to acquire, hold, and dispose of property and the ability to sue and be sued by strangers or members, which are characteristic of a corporation; and also frequently affords the limitation of liability and other advanages characteristic of a corporation. These advantages which the trust form provides are frequently referred to as resemblance to the general form, mode of procedure, or effectiveness in action, of an association or a corporation, or as "quasi-corporate form." The effectiveness in action in the case of a trust or of a corporation does not depend upon technical arrangements or devices such as the appointment or election of a president, secretary, treasurer, or other "officer", the use of a "seal", the issuance of ceraificates to

the beneficiaries, the holding of meetings by managers or beneficiaries, the use of a "charter" or "by-laws", the existence of "control" by the beneficiaries over the affairs of the organization, or upon other minor elements. They serve to emphasize the fact that an organization possessing them should be treated as a corporation, but they are not essential to such classification, for the fundamental benefits enjoyed by a corporation, as outlined above, are attained, in the case of a trust, by the use of the trust form *itself*. The Internal Revenue Code disregards the technical distinction between a trust agreement (or declaration) and ordinary articles of association or a corporate charter, and all other differences of detail. It treats such a trust according to its essential nature, namely, as an association. This is true whether the beneficiaries form the trust or, by purchase or otherwise, acquire an interest in an existing trust.

The mere size or amount of capital invested in the trust is of no importance. Sometimes the activity of the trust is a small venture or enterprise, such as the division and sale of a parcel of land, the erection of a building, or the care and rental of an office building or apartment house; sometimes the activity is a trade or business on a much larger scale. The distinction is that between the activity or purpose for which an ordinary strict trust of the traditional type would be created, and the activity or purpose for which a corporation for profit might have been formed.